

refusing to compete, not one RBOC has come forward to make a showing that potential competitors are failing to negotiate in good faith or failing to meet their schedules.

- o All the RBOCs need do is prove the claims they have been making in the press before the state public utility commission and they will overcome the first hurdle to entry. None has done so.

The Consumer Advocate and the Florida staff conclude that BST does not face a facilities-based competitor, even though requests for interconnection have been made. The DOJ found that BST does not face a facilities-based competitor, but it could not determine definitively, whether a request had been made. In either case, Track B is not available.

### **C. TRACK B**

Lacking a facilities-based competitor in South Carolina and failing to make a showing the potential competitors have not lived up to their part of the bargain, BST has tried to redefine the standard by which the competitive situation should be measured (see Attachment 2 Chapter 2, section C).

The Florida staff concluded that

- o BST does not meet the Track A requirement,
- o can not use the Track B requirement,
- o would not meet the Track B requirement, even if it could proceed under that option, and
- o has incorrectly tried to combined Track A and Track B to get around its fundamental failure to meet either.

Table 2 summarizes the states of the section 271(c)(1) test in South Carolina.

TABLE 2  
BELL SOUTH  
SECTION 271 [C] (1) COMPLIANCE EVALUATION  
FACILITIES BASED COMPETITION

ENTRY CONDITION	STATUS
<b>TRACK A CONDUCT</b>	
1) REQUEST	YES
2) GOOD FAITH NEGOTIATION	YES
3) ON-TIME IMPLEMENTATION	YES
4) TRACK B AVAILABLE	NO
<b>TRACK A CONDITIONS</b>	
1) PROVIDING ACCESS	NO
2) APPROVED AGREEMENT	YES
3) PREDOMINANTLY OWN FACILITIES FOR BUSINESS	YES
4) PREDOMINANTLY OWN FACILITIES FOR RESIDENTIAL	NO
5) SERVICE TO BUSINESS	YES
6) SERVICE TO RESIDENTIAL	NO
<b>TRACK B</b>	
1) GENERALLY OFFERS TO PROVIDE ACCESS AND INTERCONNECTION	NO
1) SGAT APPROVED OR PERMITTED TO TAKE EFFECT	NO
<b>COMPETITION ANALYSIS</b>	
1) IRREVERSIBLE	NO

#### **IV. THE COMPETITIVE CHECK LIST**

Recognizing that competitors would have to interconnect with the incumbent local exchange companies to offer local service and that competitors would find it difficult to supply many of the functionalities necessary for local service, the Congress imposed a series of obligations on the RBOCs. The competitive checklist is an impressive array of obligations that reflect the extremely complex and integrated nature of the modern telecommunications network (see Table 3).

Congress did more than identify specific items that had to be made available. It specified the terms and conditions on which they had to be offered. There are two crucial aspect to this problem.

##### **A. GENERAL CONDITIONS**

###### **1. Cost Based Pricing**

The first condition Congress placed on the RBOCs was the price at which they had to be offered. The importance of price is obvious. DOJ makes the observation that if a competitor does not have certainty, investment and commitments cannot be made. The first is the price which is paid (see Attachment 2 Chapter 3, section A. 1).

TABLE 3:  
THE COMPETITIVE CHECKLIST

Access or interconnection provided or generally offered by a Bell operating company to other telecommunications carriers meets the requirements of this subparagraph if such access and interconnection includes each of the following:

- (i) interconnection in accordance with the requirements of section 251 (c)(2) and section 252 (d)(1).
- (ii) non-discriminatory access to network elements in accordance with the requirements of sections 251 (c)(3) and 252(d)(1).
- (iii) non-discriminatory access to the polls, duct, conduits, and right-of-way owned or controlled by the Bell operating company at just and reasonable rates in accordance with the requirements of section 224.
- (iv) local loop transmission from the central office to the customer's premises, unbundled from local switching or other services.
- (v) local transport from the trunk side of a wire line local exchange carrier switch unbundled from switching or other services.
- (vi) local switching unbundled from transport, local loop transmission, or other services.
- (vii) non-discriminatory access to -
  - (I) 911 and E911
  - (II) directory assistance services to allow the carriers customers to obtain telephone numbers; and
  - (III) operate a call completion services.
- (viii) white pages directory listings for customers on the other carrier's telephone exchange service.
- (ix) until the date by which telecommunications numbering administration guidelines, plan, or rules are established, non-discriminatory access to telephone numbers for assignment to the other carrier's telephone exchange service customers. After that date, compliance with such guidelines, plan, or rules.
- (x) non-discriminatory access to databases and associated signaling necessary for call routing and completion.
- (xi) until the date by which the commission issues regulations pursuant to section 251 to require number portability, interim telecommunications number portability through a remote call forwarding, direct inward dialing trunks, or other comparable arrangements, with as little impairment of functioning, quality, reliability, and convenience as possible. After that date, full compliance with such regulations.
- (xii) non-discriminatory access to such services or information as unnecessary to allow the requesting carrier to implement local dialing parity in accordance with the requirements of section 251 (b)(3).
- (xiii) reciprocal compensation arrangements in accordance with the requirements of section 252 (d)(2).
- (xiv) telecommunications services available for resale in accordance with the requirements of section sections 251 (c)(4) and 252 (d)(3).

Expectations concerning future prices can be as important, or even more important, than current prices. A market will not be "irreversibly" opened to competition if there is a substantial risk that the input prices on which competitors depend will be increased to inappropriate levels after a section 271 application has been granted. Such price increase obviously could impair competitive opportunities in the future. As important, a substantial *risk* of such a price increase can impair competition *now*. Competitors that wish to use unbundled elements in combination with their own facilities will incur significant costs when they invest in their own facilities. Such investment will not be forthcoming *now* if there is a substantial risk that increases in the prices for complementary assets, i.e. unbundled elements, will raise the competitors total cost to a degree that precludes effective competition.<sup>12</sup>

The DOJ chides the South Carolina Public Service Commission for failing to establish pricing rules.

The SCPSC has not articulated a forward- looking cost methodology. Indeed, it has stated that it "has not adopted a particular cost methodology." Instead the prices contained in the SGAT were incorporated from several sources, including the BellSouth/AT&T arbitration, existing tariff rates, and rates negotiated in interconnection agreements with other carriers. There is no explanation of the costs on which there are based.<sup>13</sup>

The SCPSC has expressly refused to articulate the methodology, if any, that it will use to establish "permanent rates," and thus, there is no assurance that the permanent rates will permit efficient competition using unbundled elements...

In short, the record in this application does not establish that either current or future prices for unbundled elements will permit efficient firms to enter and compete effectively.<sup>14</sup>

DOJ concludes that this pricing uncertainty goes a long way toward explaining why local competition is lacking.

In South Carolina, BellSouth has not demonstrated that current prices permit entry

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<sup>12</sup>DOJ BST, p. 40.

<sup>13</sup>DOJ BST, p. 41.

<sup>14</sup>DOJ BST, p. 43.

and effective competition by efficient firms, and there is great uncertainty concerning the prices that will be available in the future. Given this uncertainty, is not surprising that there is no real competition using unbundled elements now, or that competitors plans to compete in the future are subject to many contingencies.<sup>15</sup>

## **2. Non-Discriminatory Access**

The second condition set by Congress was non-discriminatory access to functionalities and network elements. BST has performed poorly in making interconnection and access to parts of the network available on non-discriminatory terms (see Attachment 2 Chapter 3, Section A.2).

BellSouth's South Carolina revised SGAT is legally insufficient, because it fails to describe whether or how BellSouth will provide unbundled elements in a manner that will allow them to be combined by requesting carriers. First, the SGAT does not adequately specify *what* BellSouth will provide, the *method* in which it will be provided, or the *terms* on which it will be provided, and therefore there is no basis for finding that BellSouth is offering "non-discriminatory access to network elements in accordance with the requirements of sections 251 (c)(3) and 252 (d) (1)" as the checklist requires. Second, BellSouth's application does not demonstrate that it has the practical capability to provide unbundled elements in a manner that would permit competing carriers to comply them<sup>16</sup>.

DOJ adds the observation that one of the most damaging problems is to start marketing then find that the incumbent cannot or will not deliver, forcing the competitor to alienate its potential new customers.

Since the vast majority of local subscribers are current customers of the incumbent, if switching of customers is impeded then entry -- through any of the three modes - - would be stopped dead in its tracks. In California, for example, MCI and AT&T's efforts to enter the market were frustrated when PacBell's systems for processing resale orders broke down, causing substantial delays before customer could be switched to competitive carrier and leading those companies to end their

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<sup>15</sup>DOJ BST, pp. 40-41.

<sup>16</sup>DOJ BST, pp. 19-20.

marketing campaigns.<sup>17</sup>

Competition simply cannot get started if competitors do not know what their costs will be and have no assurances that when they win a customer they will be able to hook them up quickly and efficiently

### **3. Performance Measures**

One of the primary responses to the discrimination problem that has been proposed by the FCC and the DOJ is to insist on rigorous performance measures. Fully defined and implemented performance measurement systems are needed. BST's fall far short of what is required (see Attachment 2 Chapter 3, Section A.3). DOJ summarized this failure as follows.

In addition, BellSouth has no performance measurements for pre-ordering functions; few measurements for ordering functions; and no measurements for billing timeliness, accuracy and completeness. BellSouth is also missing numerous significant measures involving service quality, operator services, Director Assistance, and 911 functions. Also, while BellSouth has committed to measuring firm order confirmation cycle, and reject cycle time, the development of these measurements is incomplete and results are not yet available. Collectively, these deficiencies prevent any conclusion that adequate non-discriminatory performance by BellSouth can be assured now or in the future.<sup>18</sup>

### **B. INDIVIDUAL CHECKLIST ITEMS**

The extensive nature of the checklist reflects the fact that dismantling a century old monopoly that requires interconnection is a challenging problem (see Attachment 2 Chapter 14, Section B).

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<sup>17</sup>Schwartz, p. 20.

<sup>18</sup>DOJ BST, p. 47.

The practical reality is easy to understand,

- o Imagine trying to enter the market and compete with the incumbent without being able to hook up to the existing network, so that customers cannot complete their calls to customers on the incumbents network.
- o Imagine having to enter the market by building a new network from scratch (trying to catch up with the hundred year head start of the incumbent company), or being required to rent pieces of the existing network (loops, cables, or switches) at terms and conditions that were discriminatory resulting in higher prices or lower quality.
- o Imagine the difficulty of attracting customers if directory assistance, emergency service (911), or operator services cannot be provided at quality equal to the incumbent services, and not having the ability to brand those services with the company's name.
- o Imagine having to require customers to change their numbers to switch companies, or to suffer degradation in service quality to keep their numbers.
- o Imagine having to ask new customers to wait longer to place their order and have it filled, or finding their number does not work when they expect it to, or having them receive multiple bills for the same service.

These are just a few of the problems that the DOJ and the Florida staff found in the current approach of BST. Out of the 14 points on the competitive check list which Congress imposed on the RBOCs, the Florida Staff concludes that BST has not met nine (see Attachment 2 Chapter 3, Section C). Table 4 shows a summary of the areas where the BST application is deficient. The specific problems are derived from the framework that is developed in Part II. It is obvious that BST's application is severely deficient.



TABLE 4  
BELLSOUTH  
SECTION 271 [C](2)(B) COMPLIANCE  
COMPETITIVE CHECKLIST

	ITEMS								
	1	2	4	5	6	7	11	13	14
FINAL RATES, TERMS, AND CONDITIONS									
LEGAL OBLIGATIONS	N								?
STATE APPROVED AGREEMENTS									
COURT CASES	N								
INTERIM ORDERS	N	N							
USAGE RIGHTS	?								
COST-BASED RATES	N	N	N			N			N
ACCESS TO INFORMATION									
PRE-ORDER	N	N							N
ORDER		N							N
PROVISION	N	N							N
REPAIR AND MAINTENANCE	N	N							
BILLING		N	N	N	N				N
FULLY LOADED FUNCTIONING									
SUFFICIENTLY AVAILABLE	N	N							N
DEPLOYED	N								
ACCESS IN VOLUME	N	N							N
ASSISTANCE FOR USERS	N	N							N
OPERATIONALLY READY									
TESTS/PILOTS									
INTERNAL									
THIRD-PARTY	?								
INTER-CARRIER	N								
PERFORMANCE STANDARDS									
AUTOMATED		N							N
QUALITY/RELIABILITY	?	N							N
EQUAL FOR ALL	N	N		N	N	N	N	N	N
EXCLUSIONS	?	?							?
PERFORMANCE ASSESSMENT									
INSTALLATION INTERVALS	N	N	?						N
INTERFACE & INTERNAL OSS		N							N
ACCURACY		N							N
HELD ORDERS	N	?	?						?
BILL QUALITY		N	N	N	N				N
REPEAT TROUBLE	?	?	?						?
REMEDIES FOR NONCOMPLIANCE	N	N	N						N

" " = IN COMPLIANCE OR NOT APPLICABLE; N = NOT IN COMPLIANCE, " " = NOT APPLICABLE, ? = COMPLIANCE UNCLEAR

Source: Derived from Division of Communications and Division of Legal Services, Florida Public Service Commission, Memorandum, Docket No. 960786-TL - Consideration of BellSouth Telecommunications Inc.'s Entry into InterLATA Services Pursuant to Section 271 of the Federal Telecommunications Act of 1996, October 22, 1997, and Department of Justice, "Evaluation of the United States Department of Justice," Federal Communications Commission, In the Matter of Application by BellSouth Corporation, et. al. for Provision of In-Region, InterLATA Services in South Carolina, CC Docket No. 97-208, September 30, 1997.

Table 5 presents a list of problems identified by the Florida staff in just one of the checklist items, BellSouth's resale obligation. This is checklist item xiv, as well as an obligation specifically identified in sections 251 and 252 of the Act. This is the path to competition that most competitors would be forced to take if the RBOCs achieved premature entry into the in-region long distance market. It is easy to see why competitors would have trouble getting into the local market. Similar barriers to entry can be found on the other two paths that the Act opened up, facilities-based competition and combination of unbundled network elements.

One conclusion is overwhelmingly clear from the analysis of the BST application

- o Local competition is not happening because the incumbent local exchange companies do not want it to and are resisting.

It is premature to verify compliance with section 271 requirements, or to be more accurate, is premature to allow BellSouth to eat the carrot before the destination is reached. By BellSouth's own admission, it has not fulfilled all the requirements under section 271's "competitive checklist." We strongly suggest the Commission verify that BellSouth has not complied with the section 271 requirements.. Since BellSouth cannot show that it has "fully implemented the competitive checklist in subsection (c)(2)(B)" (as required by section 271 (d) (3) (a) (I)), the Commission should withhold verification of BellSouth compliance with section 271.<sup>19</sup>

The DOJ analysis agrees with this assessment, although not at the same level of detail.

There are several problems that underlie this failure.

First, important terms and conditions upon which Bell South has proposed to open its network do not meet the requirement that they be just, reasonable and non-discriminatory.

Second, important terms and conditions are simply unknown and uncertain.

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<sup>19</sup>Buckalew, p. 17.

TABLE 5  
PROBLEMS IN PROVISION OF NON-DISCRIMINATORY ACCESS  
TO RESOLD SERVICES IN THE BELL SOUTH REGION

OPERATING SUPPORT SYSTEM PROBLEMS

PRE-ORDERING

- 1: Multiple address validation for the same fields in different screens
- 2: No on-line customer credit checking capability and limited availability of customer services record information.
- 3: Requires human intervention
- 4: BST can reserve more telephone numbers than ALECs
- 5: Cumbersome and inefficient methods of locating long distance company selected by customers and product service information
- 6: Does not provide access to calculated due dates in the inquiry mode

ORDERING AND PROVISIONING

1. Do not have electronic capability at parity with BST's
2. No order summary screen exists
3. Intervenors cannot access or make changes to pending orders.
4. BST has not provided requesting carriers with the technical specifications of the interfaces.
5. Interfaces are not fully electronic or integrates.
6. Insufficient capacity to meet demand.
7. Insufficient testing and documentation.

MAINTENANCE AND REPAIR

1. A proprietary system that does not provide ALECS with machine-to-machine functionality
2. Interface lacks sufficient capacity to meet demand.

BILLING

1. BellSouth cannot render accurate bills for resold services

RESALE PROBLEMS

1. Voice mail service is not being provided on an unbranded basis
2. Disparity in conversion of customers
3. Manual ordering

Source: Division of Communications and Division of Legal Services, Florida Public Service Commission, Memorandum, Docket No. 960786-TL - Consideration of BellSouth Telecommunications Inc.'s Entry into InterLATA Services Pursuant to Section 271 of the Federal Telecommunications Act of 1996, October 22, 1997, pp. 263-283.

Third, even where the terms and conditions in its contracts (or tariffs) are just, reasonable and non-discriminatory on paper, BST has failed to fulfill their obligations. They have not lived up to the terms and conditions they have agreed to. The DOJ summarizes the current situation with respect to the most fundamental question, interconnection of networks, as follows:

At this time, BellSouth faces no significant competition in local exchange services in South Carolina. Lacking this best evidence that the local market has been opened to competition, the Department cannot conclude that its competition standard is satisfied unless BellSouth shows that significant barriers are not impeding the growth of competition in South Carolina. BellSouth has not done so in this application.<sup>20</sup>

The recommendation of the DOJ, the consumer advocate, and the staff in Florida to reject BST entry under the circumstances is correct. If these are the terms and conditions under which competitors must move forward, then meaningful competition will not be forthcoming and the 1996 Act will be a major failure. Not only should the FCC reject the application for entry into in-region interLATA services, but regulators need to go on the offensive, requiring incumbents to live up to their responsibilities and using all available sanctions where they do not.

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<sup>20</sup>DOJ BST, p. iv.

**PART II:**

**ATTACHMENT 1:**

**LAST CHANCE FOR LOCAL COMPETITION:**

**SECTION 271 POLICIES TO OPEN LOCAL MARKETS**

## **I. INTRODUCTION**

### **A. A CRUCIAL DECISION**

The issue in the section 271 proceedings is simple.<sup>21</sup>

Have the Baby Bells loosened their hold on their hundred year old monopoly over local telephone service enough to ensure that competition in local service will benefit consumers and provide for fair competition in long distance markets?

Consumers have a huge stake in the answer to this question. Not only do they spend over \$150 billion per year on telecommunications services, but the telecommunications network is the on-ramp for the information superhighway. Open competitive access to information services will be crucial to determining political, social and economic opportunities in the 21st century.

The purpose of this paper is to present a comprehensive consumer view of the entry of RBOCs into in-region, interLATA long distance. It relies entirely on the observation of third parties about the legal and economic conditions that have been placed on entry. That is, we ignore the special pleadings of the RBOCs, potential local service competitors, and the long

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<sup>21</sup> As of late September 1997, there have been two requests for entry into long distance. Ameritech has tried to enter in Michigan twice. All references to Michigan in this part refer to the initial applications (Michigan Public Service Commission, In the Matter of the Commission's Own Motion to Consider Ameritech Michigan's Compliance with the Competitive Check List in Section 271 of the Telecommunications Act of 1996, Case No. U-11104; Federal Communications Commission, In the Matter of Application by Ameritech Michigan to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Service in Michigan, CC Docket 97-1. References to the Federal Communications Commission action in response to the Michigan Request are to Federal Communications Commission, Memorandum Opinion and Order In the Matter of Application by Ameritech Michigan to Section 271 of the Telecommunications Act of 1996, as amended, to Provide In-Region, InterLATA Service in Michigan, CC Docket 97-13, August 19, 1997 (hereafter FCC Michigan). SBC has tried to enter in Oklahoma (Oklahoma Corporation Commission, Cause NO. PUD 97-64) Federal Communications Commission, In the Matter of Application of SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., d/b/a Southwestern Bell Long Distance for Provision of In-Region InterLATA Services in Oklahoma, CC Docket No. 97-121. As has become the norm in the implementation of the Telecommunications Act of 1996, there are also two court cases, one for each of the FCC decisions.

distance industry. Instead we rely on the analyses of Attorneys General, Consumer Advocates, and Public Utility Commissions. In each section we discuss comments by various state agencies, the Department of Justice, and conclude with the FCC position, which will be dispositive of any request for entry into interLATA markets.

## **B. OUTLINE OF THE PAPER**

The next chapter, Chapter II presents a brief explanation of the stakes for consumers. An assessment of the stakes plays an especially important role in this area. Because the decision about entry requires policy makers to strike a balance between potential competitive benefits in the local and long distance industries and potential anti-competitive behaviors, it is crucial for consumer commentators to quantify the stakes.

Chapter III describes the process outlined in the 1996 Act for the decision about RBOC entry into in-region, interLATA long distance. Under the Act, the RBOCs must seek authorization and show that they have satisfied the conditions established by Congress. Unfortunately, even the most basic questions of which issues can be raised have become a bone of contention.

Finally, the comments present a discussion of each of the four major steps in deciding whether or not RBOCs should be allowed to sell in-region long distance. Chapter IV reviews the requirement for the presence of facilities-based competition prior to entry of RBOCs into in-region long distance. Chapter V then reviews the competitive check list items that must be provided by RBOCs. Chapter VI turns to the safeguards for affiliate transactions that must be in place. Chapter VII discusses the broad public interest standards that must be applied.

## **II. THE CONSUMER INTEREST IN EFFECTIVE COMPETITION IN TELECOMMUNICATIONS MARKETS**

### **A. THE CENTRAL PUBLIC POLICY ISSUE**

The Department of Justice has succinctly summarized the public policy balance that Congress struck in the 1996 Act when it addressed the issue of RBOC entry into in-region long distance.

InterLATA markets remain highly concentrated and imperfectly competitive, however, and it is reasonable to conclude that additional entry, particularly by firms with the competitive assets of the BOCs, is likely to provide additional competitive benefits.

But Section 271 reflects Congressional judgements about the importance of opening local telecommunications markets to competition as well. The incumbent local exchange carriers (LECs), broadly viewed, still have virtual monopolies in local exchange service and switched access, and dominate other local markets as well. Taken together, the BOCs have some three-quarters of all local revenues nationwide, and their revenues in their local markets are twice as large as the net interLATA market revenues in their service areas. Accordingly, more considerable benefits could be realized by fully opening the local market to competition.<sup>22</sup>

In short, Congress recognized that opening the local monopoly to competition was far more important than adding more competition in the long distance market.

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<sup>22</sup> "Evaluation of the United States Department of Justice, Federal Communications Commission, In the Matter of Application of SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., d/b/a Southwestern Bell Long Distance for Provision of In-Region InterLATA Services in Oklahoma, CC Docket No. 97-121, May 16, 1997 (hereafter, DOJ, SBC), p. 4.



## **B. ECONOMIC IMPORTANCE OF COMPETITIVE REFORM IN TELECOMMUNICATIONS MARKET**

A quick look at the numbers reinforces the fundamental observation that there is a lot more at stake for consumers in the local market (see Table 1).

- o The local market is approximately twice as large as the long distance market.
- o The level of concentration in the local market is about three times as high.
- o RBOCs have excessive rates of profit.
- o Potential consumer savings resulting from the introduction of competition into the local market is close to \$10, several orders of magnitude greater than potential savings in long distance.

Consumers spend over \$90 billion on local service, compared to about \$50 billion in long distance. This does not include yellow pages and other unregulated activities of the LECs. It excludes cellular revenues for both LECs and IXC.

The Department of Justice estimates that the current long distance market is a highly concentrated market, as measured by the Hirschman Herfindahl Index (HHI). The Department of Justice uses an HHI of 1800 as the point at which it considers a market highly concentrated (see Appendix B for a description of the meaning of these concentration measures). DOJ considers an HHI of 1000 to identify a moderately concentrated market. With an HHI of 3200, the long distance market is far above the threshold for a highly concentrated market.

TABLE 1  
CHARACTERISTICS OF THE LOCAL EXCHANGE AND  
LONG DISTANCE INDUSTRIES

	LONG DISTANCE	LOCAL
	a/	a/
REVENUE (\$, billion)	50	93
	b/	c/
CONCENTRATION (Hirshman Herfindahl Index)	3200	9200
	d/	
RETURN ON EQUITY (1994-1996)	14.8	23.3
	e/	
EXCESS PROFITS (\$, billions, Including Tax Effects)	0-2	8-12

a/ "Affidavit of Marius Schwartz," Evaluation of the United States Department of Justice, In the Matter of Application of SBC Communications Inc. Et.al. Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in the State of Oklahoma, CC Docket NO. 97-121, May 16, 1997, Table 1.

b/ Evaluation of the United States Department of Justice, In the Matter of Application of SBC Communications Inc. Et.al. Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in the State of Oklahoma, CC Docket NO. 97-121, May 16, 1997.

c/ "Affidavit of Marius Schwartz," Evaluation of the United States Department of Justice, In the Matter of Application of SBC Communications Inc. Et.al. Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in the State of Oklahoma, CC Docket NO. 97-121, May 16, 1997, Table 1. Excludes miscellaneous revenues. Assumes CAP, CLEC and IntraLATA long distance revenues as the competitors' market share.

d/ "Performance Ranking of the S&P 500," Business Week, March 24, 1995

e/ See appendix A.

However, the local market is even more concentrated. Using national figures for revenues earned by competitive access providers (CAPs) and competitive local exchange companies (CLECs), as well as intraLATA long distance competition, we conclude that incumbent LECs have a 96 percent market share.<sup>23</sup> This yields a HHI index of 9200, almost three times that of the long distance market. Calculating concentration on a state-by-state basis, using the data provided in the Section 271 filings of both Ameritech (Michigan) and SBC (Oklahoma) the results would show an even more highly concentrated market. The market share of the LECs is still 99 percent.

Reflecting the different levels of competition in the two industry segments, we observe a much higher level of profitability in the LEC segment. In 1994-1996 period, the large LECs (the seven Baby Bells plus GTE) earned an average return on equity of over 23 percent. This was well above the national average for large firms of about 16 percent. Over the same period, the three largest firms in the long distance industry earned a return on equity of about 15 percent, somewhat below the national average. While long distance profits have bounced around, local profits have consistently exceeded the national average and have been growing very rapidly.

Reflecting both the size of the two industry segments and the different levels of competition, the gains to consumers from an increase in competition in each is dramatically different. If competition were to drive return on equity down to the national average in both segments, consumers would see benefits that are at least four times as large in the local service market. Vigorous competition would lower prices charged for local service by between \$8 billion and \$12 billion. In long distance there appears to be at most \$2 billion of excesses that could be

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<sup>23</sup> The market share for residential customers is well over 99 percent. As measured by lines, the market share of LECs is above 96 percent.

squeezed out.<sup>24</sup> There is just a lot more fat to be squeezed out through local competition.

### **C. PUBLIC POLICIES TO SECURE COMPETITION**

Reflecting the more highly developed level of competition in the long distance industry segment and the fact that local exchange markets are a bottleneck input for long distance markets, Congress placed its emphasis on ensuring that local markets would be competitive. While the long distance oligopoly could be expected to perform better if greater competitive forces were brought to bear in it, the crucial barrier to competition in the telecommunications industry is the local monopoly.

Section 271 reflects Congress' recognition that the BOCs' cooperation would be necessary, at least in the short run, to the development of meaningful local exchange competition, and that so long as a BOC continued to control local exchange markets, it would have the natural economic incentive to withhold such cooperation and to discriminate against its competitors. Accordingly, Congress conditioned BOC entry on completion of a variety of steps designed to facilitate entry and foster competition in local markets.<sup>25</sup>

The FCC took the opportunity of its first 271 decision to outline in detail the competitive advantage the local companies have in entering the long distance market compared to other companies entering the local market.

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<sup>24</sup> It has been widely noted that the local companies that have been allowed to enter into long distance have not competed vigorously on price (See Bear Stearns, Telecommunications Services, July 30, 1996; Merrill Lynch, Telecommunications Services, 14 May, 1996; J.P. Morgan, Telecommunications Review, July 16, 1996). The FCC Michigan notes this as well (para. 15).

The recent successes of Southern New England telecommunications Corp. and GTE in attracting customers for their long distance services illustrates the ability of local carriers to garner a significant share of the long distance market.

<sup>25</sup> DOJ, SBC, pp. 4-6.

The most crucial observation is to recognize, as the Antitrust court had,<sup>26</sup> the power inherent in the incumbent monopoly status of the local exchange companies. These advantages include<sup>27</sup>

a history of legal barriers,

economic and operational barriers,

the fully deployed, ubiquitous network of the incumbents which lowers their incremental cost of entering other markets, and

the need for interconnection.

Not only do the incumbent local exchange companies have an advantage in the market

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<sup>26</sup> FCC Michigan, para 10.

The court found that, if the BOCs were permitted to compete in the interexchange market, they would have "substantial incentives" and opportunity, through their control of local exchange and exchange access facilities and services, to discriminate against their interchange rivals and to cross subsidize their inter-exchange ventures...

<sup>27</sup> FCC Michigan, paras. 11...12.

For many years the provision of local exchange service was even more effectively cordoned off from competition than the long distance market. Regulators viewed local telecommunications markets as natural monopolies, and local telephone companies, the BOCs and other incumbent local exchange carriers, often held exclusive franchises to serve their territories. Moreover, even where competitors legally could enter local telecommunications markets, economic and operational barriers to entry effectively precluded such forays to any substantial degree...

These economic and operational barriers largely are the result of the historical development of the local exchange markets and the economics of local networks. An incumbent LEC's ubiquitous network, financed over the years by the returns on investment under rate of return regulation, enables an incumbent LEC to serve new customers at a much lower incremental cost than a facilities based entrant that must install its own network components. Additionally, Congress recognized that duplicating the incumbents local networks on a ubiquitous scale would be enormously expensive. It also recognized that no competitor could provide a viable, broad-based local telecommunications service without inter-connecting with the incumbent LEC in order to complete calls to subscribers served by the incumbent LECs network.

power they possess in the local market, but entry into the long distance market will be relatively easy for them because of the more competitive structure of that market.<sup>28</sup> The ease of entry stems from a number of factors including

brand recognition,

a fully deployed network, and

a mature market where switching and resale are common.

With this understanding of the advantages of the incumbents, the provisions of section 271 seek to redress the imbalance of market power between local companies and their potential competitors. The FCC notes that it was this competitive imbalance that Congress sought to

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<sup>28</sup> FCC Michigan, para 15...17.

Indeed given the BOCs strong brand recognition and other significant advantages from incumbency, advantages that will particularly redound in the broad-based provision of bundled local and long distance services, we expect that the BOCs will be formidable competitors in the long distance market and, in particular, in the market will bundled local and long distance services. ...

Significantly, however, the 1996 act seeks not merely to enhance competition in the long distance market but also to introduce competition to local telecommunications markets. Many of the new entrants, including the major inter-exchange carriers, and the BOC, should they enter each other's territories, enjoy significant advantages that make them potentially formidable local exchange competitor hours. Unlike BOC entry into long distance, however, the competing carriers entry into the local market is handicapped by the unique circumstance that their success in competing for BOC customers depends upon the BOCs' cooperation. Moreover BOCs will have access to a mature, vibrant market in the resale of long distance capacity that will facilitate their rapid entry into long distance and consequently their provision of bundled long distance and local service. Additionally, switching customers from one long distance company to another is now a time tested, quick, efficient, and inexpensive process. New entrants into the local market, on the other hand, do not have available a ready, mature market for the resale of local service or for the purchase of unbundled network elements, and the process for switching customers for local service from the incumbent to the new entrant are novel, complex and still largely untested. For these reasons, BOC entry into long distance market is likely to be much easier than entry by potential BOC competitors into the local market, a factor that may work to BOC advantage in competing to provide bundled service.

address in Section 271.

By requiring BOC to demonstrate that they have opened their local markets to competition before they are authorized to enter into the in-region long distance market, the 1996 act enhances competition in both the local and long distance markets.

If the local market is not open to competition, the incumbent will not face serious competitive pressure from new entrants, such as the major interexchange carriers. In other words, the situation would be largely unchanged from what prevailed before the 1996 act. That is why we must ensure that, as required by the Act, a BOC as fully complied with the competitive checklist. Through the competitive checklist and the other requirements of section 271, Congress has prescribed a mechanism by which the BOC may enter the in-region long distance market. This mechanism replaces the structural approach that was contained in the MFJ by which BOCs were precluded from participating in that market.<sup>29</sup>

It is because of the clear advantages that incumbent local exchange companies possess and the failure of other sections of the 1996 Act to produce even a hint of competition that we believe the section 271 proceedings are the last chance for local competition. Without section 271, there was little in the Act to give the BOCs incentives to open their markets.<sup>30</sup>

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<sup>29</sup> FCC Michigan, paras 15...18.

<sup>30</sup> FCC Michigan, para 14.

A salient feature of these market opening provisions is that a competitor's success in capturing local market share from the BOCs is dependent, to a significant degree, upon the BOCs' cooperation in the non-discriminatory provision of interconnection, unbundled network elements and resold services pursuant to the pricing standards established in the statute. Because the BOCs, however, have little, if any, incentive to assist new entrant in their efforts to secure a share of the BOCs' markets, the Communications Act contains various measures to provide this incentive, including section 271. Through this statutory provisions, Congress required BOCs to demonstrate that they have opened their local telecommunications markets to competition before they are authorized to provide in-regions long distance services. Section 271 creates a critically important incentive for BOCs to cooperate in introducing competition in their historically monopoly local telecommunications markets

### **III. THE PROCESS OF INTRODUCING COMPETITION INTO LOCAL MARKETS**

In the 1996 Act Congress set a broad goal of "opening all telecommunications markets to competition." It recognized that different markets posed different problems. Because local markets would be particularly difficult, it imposed special conditions on local service companies. In sections 251 and 252 of the 1996 Act, it imposed a series of requirements on all local exchange companies, as well as specific requirements on incumbent local exchange companies.

Having identified the basic conditions for local competition, the Congress turned to the question of entry by RBOCs into in-region long, interLATA distance. Unsatisfied that the general requirements placed on the RBOCs to open their networks to competition would be effective, the Congress required additional conditions and oversight by other agencies before the RBOCs would be allowed to sell in-region long distance (see Table 2). The Congress required the FCC to make findings in four areas before RBOCs were to be allowed into in-region long distances. These findings were to be made in consultation with the states and the Department of Justice (whose advice was to be given substantial weight).<sup>31</sup>

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<sup>31</sup> DOJ, SBC, pp. 7-8.

Section 271 establishes four basic requirements for long distance entry. The first three such requirements -- satisfaction of Section 271 [c] (1) (A) (Track A) or Section 271 [c](1)(B)(Track B), the competitive check list, and Section 272 -- establish specific, minimum criteria that a BOC must satisfy in all cases before an application may be granted. In addition, Congress imposed a fourth requirement, calling for the exercise of discretion of the Department of Justice and the Commission. The Department is to perform competitive evaluation of the application. "Using any standard the Attorney General considers appropriate." And, in order to approve the application, the Commission must find that "the requested authorization is consistent with the public interest. In reaching its conclusion on a particular application, the Commission is required to give "substantial weight to the Attorney General's evaluation."



TABLE 2  
PROCESS FOR APPROVING RBOC ENTRY INTO  
IN-REGION, INTERLATA LONG DISTANCE

